



FINANCING METROPOLITAN GOVERNMENTS *in* DEVELOPING COUNTRIES

Edited by

ROY W. BAHL, JOHANNES F. LINN, AND DEBORAH L. WETZEL



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EXTERNAL ASSISTANCE FOR URBAN FINANCE DEVELOPMENT

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Needs, Strategies, and Implementation

HOMI KHARAS AND JOHANNES F. LINN

The World Development Report (World Bank 2009b) describes cities as vital to economic growth. In successful countries, cities provide scale economies, efficiencies in logistics, and, in the provision of public services, dense labor markets that foster training and skills acquisition, innovation and creativity, diversification of production, lower environmental footprint through densification, and, ultimately, greater freedom for the individuals who live there. However, cities do not provide these benefits automatically or for free. City management is a complex undertaking of institutional development and governance; planning, partnerships, and consultations with the myriad stakeholders within cities; and considerable amounts of financing. Absent this, cities can generate problems as easily as benefits (see chapter 2).

The 2009 World Development Report also describes the billion slum dwellers in the developing world's cities. The international aid community has long recognized the pervasive effects of poverty, illiteracy, and mortality in slums and established a specific target as part of the U.N. Millennium Development Goals (MDGs): "By 2020, to have achieved a significant improvement in the lives of 100 million slum dwellers" (United Nations, n.d.). However, the U.N. Millennium Indicators monitoring site (United Nations 2012) shows that there are 100 million more slum dwellers than in 1990, as rapid urbanization offsets modest progress in improving the lives of those already in cities. The problem is especially severe and growing rapidly in Africa. A 2005 report of the Commission for Africa, chaired by Tony Blair, identified urbanization as the second most important challenge facing Africans, after the HIV/AIDS pandemic. The reasons are clear: sub-Saharan Africa has a staggering 71 percent of its urban population in slums, so business as usual is unacceptable (Commission for Africa 2005).

There is widespread agreement about the need for action in response to these opportunities and challenges. There is advocacy on the modalities through which

assistance can be made: policy support and investments. There are now measurable targets at the global level, and a number of international organizations are dedicated solely to promoting urban development.¹ However, there is a sense in the development community that urban development has a low priority for donors, that funding is declining, that strategies are not acted upon, and that new approaches are needed even as it would seem obvious that external assistance should play a central role in urban development. The very fact that slum upgrading is included in the MDGs (along with other indicators that must be addressed at a spatial level, e.g., education, health, and poverty) shows that there is broad recognition that urban development issues can be resolved only by a combination of national and international policies if countries are to attain the speed and efficiency of urban improvements that are needed to meet the MDG targets.

Among the national and local policies that will be critical for meeting the needs of the rapidly growing areas in developing countries are those that determine the effective mobilization of financial resources for urban service provision, their efficient and equitable allocation to urban development priorities, and their effective management. International assistance can and should, therefore, not only aim to help meet the immediate funding needs but also contribute to improve the urban financial resource mobilization and management capacity.

This chapter addresses two sets of questions: (1) what is known about the amounts of aid that support urban development in developing countries relative to financing needs, and what needs to be done to assure accurate data to assess the amounts and trends of these flows; and (2) what is known about the strategic objectives and operational approaches followed by aid donors regarding urban development, especially regarding urban finance improvements, and about the effectiveness of the aid flows to urban areas in terms of their impacts in improving urban service provision and in raising the capacity to improve urban finance mobilization and management.

AID FOR URBAN DEVELOPMENT: PATTERNS, TRENDS, AND DATA ISSUES

This section reviews external assistance for urban development by assessing the need for urban assistance and by documenting trends in aid going into urban projects and programs. The section closes with a brief discussion of the determinants of urban aid as a share of total aid. Unfortunately, the analysis is constrained by the limited information available on the amount of support donors give specifically for urban or metropolitan city development.

Financing Needs

Urban financing needs are difficult to assess. Although there is no globally accepted figure for the level of overall investment requirements to make cities work well, ballpark estimates are available from various sources. The Zedillo report of the

¹The U.N. Human Settlements Programme (UN-HABITAT) and Cities Alliance are among the most prominent.

U.N. High-Level Panel on Financing for Development (2001) estimates that additional resources of \$4 billion per year would be required to achieve the MDG target of a significant improvement in the lives of 100 million slum dwellers by 2020.

The Asian Development Bank (AsDB), based on its experience with slum upgrading projects in Asia, estimates that \$1,520 would be required per household in a slum to upgrade water supply (\$400), sanitation (\$700), solid waste management (\$120), and the physical environment (\$300) (AsDB 2006).² Applying this estimate globally implies a cost of \$3.4 billion per year.³

However, dealing with existing slum dwellers does not take into account new migrants who continue to pour into urban slums. The global slum population is considered to be more than 1 billion people; thus, assuming that the growth of slum dwellers is the same as the rate of urbanization (2.2 percent per year), there would be an increase of 20 million slum dwellers per year from now to 2020. Added to the desired reduction of 10 million slum dwellers a year to meet the MDG target, this means that around \$5 billion per year is needed just for slum improvements.

In addition to reducing the number of slum dwellers, urbanization requires achieving efficiency in the management of the growth of cities. In fact, financing requirements for city infrastructure projects are considerably greater than those required for slum upgrading. The AsDB (2006) estimates that its member countries' cities need \$60 billion per year to function effectively, of which about half is currently met from all sources, public and private, domestic and international. Applying these estimates globally indicates urban public investment of about \$120 billion per year. Of course, most of this must come from each country's own resources, but a significant fraction is needed from external assistance.

External Financial Resources for Urban Development

Finding a comprehensive measure of official development assistance (ODA) for urban development is difficult. Locational tags indicating whether a project is urban or rural are not used systematically while recording aid data. For example, if one adds up all projects labeled as either urban or rural in the ODA database of the Organisation for Economic Co-operation and Development's Development Assistance Committee, the total only amounts to 9 percent of all projects. This cannot be the case in practice but probably reflects the ambiguity in defining what constitutes urban aid. It remains unclear whether investment in a city school should be classified as an "urban" or an "education" investment. Currently, other themes, such as gender or climate change, which cut across different areas, use markers to identify if the project has the theme of "principal target," "significant target," or "not targeted," but this is not the case for urban or rural projects. As a first step toward measuring urban aid, it would be useful for all donors to apply a meaningful urban marker system. Absent that, it will remain difficult to assess the trends in urban foreign assistance and the gaps between resources and needs.

²These are expenditures required to convert a household from a slum dwelling to a nonslum dwelling.

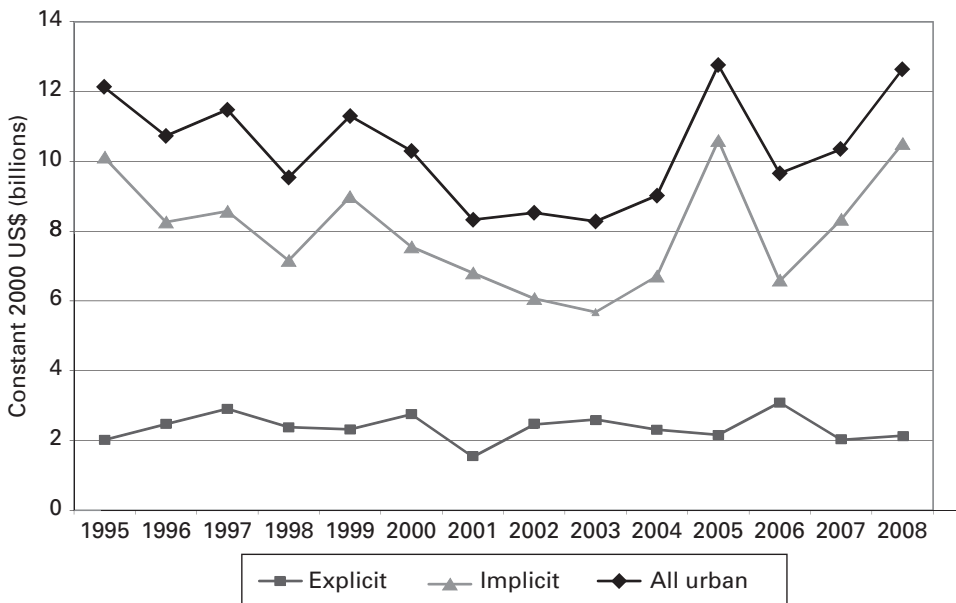
³This is calculated taking the average household size as five and setting a goal of eliminating 100 million slum dwellers over nine years.

With this caveat, it is nonetheless possible to make some estimates for urban aid commitments. Following the methodology in Kharas, Chandy, and Hermias (2010), a series of ODA for urban projects was developed using the AidData web portal (AidData 2011), which provides access to information on all ODA and non-concessional loans of multilateral agencies like the World Bank and the AsDB (Findley et al. 2009). AidData aggregates data from multiple sources and provides a searchable database of global aid flows and projects. AidData allows for multiple sector and activity codes per project (unlike Development Assistance Committee data), so even if a project is largely sectoral (e.g., wastewater), it will show up as an urban project if there is a component with urban objectives, such as urban policy, planning, and management. This is often the case for urban projects where specific investments are used as the entry point for a broader discussion of urban policy issues with city officials. As explained below, loans, grants, and credits are identified that expressly target “explicit” and “implicit” urban objectives.

Explicit urban projects are all those that are coded with one or more of the following three purpose codes: urban development and management; low-cost housing; or housing policy and administration management. In 2008, ODA commitments from bilateral and multilateral sources that were marked with these purpose codes were \$2.14 billion (figure 15.1). They represented approximately 1.2 percent of the \$176 billion total ODA and nonconcessional loans committed that year (figure 15.2). The value of explicit urban commitments has not changed significantly over the last 14 years when measured in constant dollars. In fact, the level of commitments in 2008 was almost exactly the same as in 1995. Temporary spikes in

FIGURE 15.1

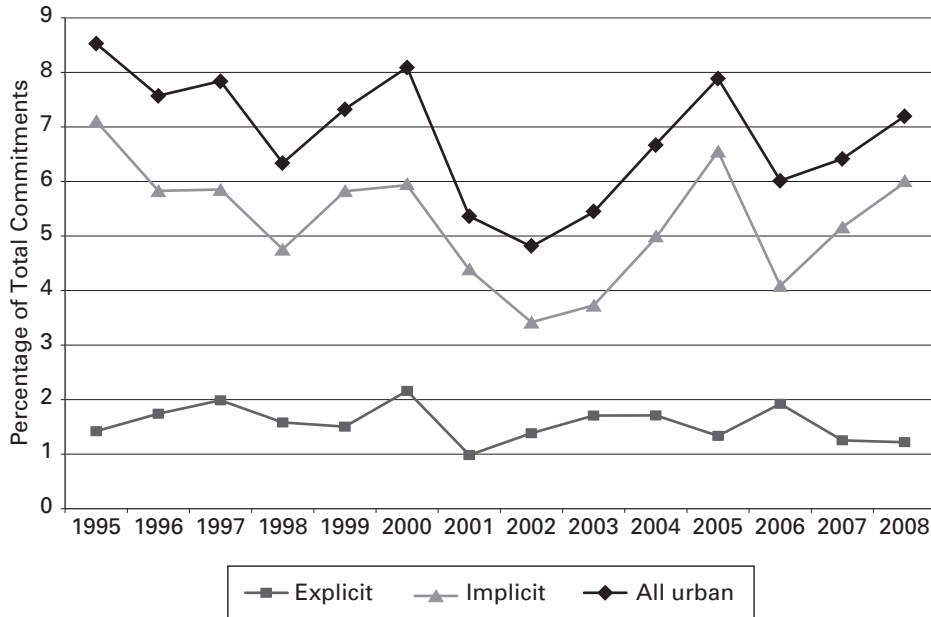
Urban aid commitments, 1995–2008



SOURCE: Data from AidData (2011).

FIGURE 15.2

Urban aid commitments as percentage of total aid, 1995–2008



SOURCE: Data from AidData (2011).

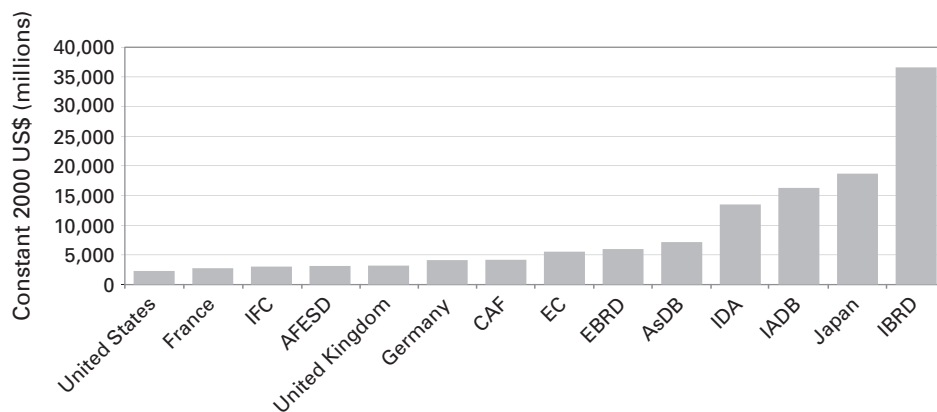
1997, 2000, and 2006 were quickly reversed, suggesting that a few large projects may have been approved in these years, followed by a return to normal-size projects.

Implicit urban projects are imputed by searching all project titles, as well as their long and short descriptions, for a set of keywords that might indicate they have an urban purpose, even if not explicitly stated in the purpose code. Keywords include “urban,” “city,” “cities,” “slum,” “slums,” “municipal,” and “metropolitan,” as well as a list of city names. The list of cities was drawn from the Economist Intelligence Unit’s cost of living database (http://www.worldwidecostofliving.com/asp/wcol_WCOLHome.asp). It includes 76 developing country cities, including many capital cities. Implicit urban projects exclude explicit urban projects, so the total amount of foreign assistance for urban objectives is obtained by summing the two series. In 2008, there was \$10.5 billion of external assistance in implicit urban projects from bilateral and multilateral sources, and about \$12.6 billion in total urban assistance (figure 15.1). That is about 10 percent of global funding needs tentatively identified above.

Although over the last 10 years there is a slight upward trend in total urban aid, overall the amounts going toward urban development are small compared with needs. Expressed as a share of total bilateral and multilateral support, urban aid is on a flat to moderately declining trend, amounting to about 7 percent of total aid in recent years (figure 15.2). It would appear that other sectors have been more effective in gaining donor attention and funding support. The intention of the MDG slum reduction target, to focus the international community on global urban issues,

FIGURE 15.3

Urban aid commitments by donor, 1995–2008



Abbreviations, AFESD, Arab Fund for Economic and Social Development; AsDB, Asian Development Bank; CAF, Caja Andino de Fomento; EBRD, European Bank for Reconstruction and Development; EC, European Commission; IADB, Inter-American Development Bank; IBRD, International Bank for Reconstruction and Development (World Bank); IDA, International Development Association (World Bank); IFC, International Finance Corporation.

SOURCE: Data from AidData (2011).

does not seem to have had an impact on increasing urban aid. As figure 15.1 reveals, urban aid may have actually fallen in 2001, just after the MDGs were adopted, and only after 2004 did they start to recover. Thus, it seems that urban aid has flatlined (see also Stren 2007).

In contrast to many other aid activities, urban aid is relatively concentrated and hence does not have the same kind of large coordination costs that are seen in other thematic areas, such as health and education.⁴ While 44 donors have nonnegligible urban programs (i.e., they have committed more than \$100 million to urban projects since 1995), only 22 have commitments of more than \$1 billion each, and the top four donors accounted for 57.8 percent of all commitments. Multilateral agencies seem most oriented toward urban development; all of the top eight donors except Japan are multilateral agencies (figure 15.3). The World Bank is by far the largest donor to urban projects, with both the International Bank for Reconstruction and Development (\$36 billion in commitments) and International Development Association (\$13 billion) having significant programs.

Under what circumstances do countries receive a high share of urban aid? To answer this question, the share of urban aid in total aid was regressed on a number of country and donor characteristics. Based on figure 15.3, countries with a high share of multilateral aid are expected to also have a relatively high share of urban aid because multilaterals appear to have large urban programs. The urban share of the total population gives an indicator of the need for urban aid. Also included is a variable on government effectiveness, a summary indicator taken from the World Bank's Worldwide Governance Indicators, capturing perceptions of the quality of

⁴However, this does not preclude scattered and uncoordinated activities, for example, in Bangladesh (see box 15.2).

a country's bureaucracy. Finally, a variable on aid dependency is included, defined as the ratio of aid to the recipient country gross domestic product. Regional dummies complete the model.

Table 15.1 shows the results of an ordinary least squares regression on the determinants of the share of urban aid in total commitments from 1995 to 2008, covering 98 recipient countries. The results from this regression suggest that the share of urban aid received by a recipient country depends positively on the share of multilateral aid in total aid, recipient government effectiveness, and total aid levels. In contrast, the need for urban aid, proxied by the urban share of the population, is insignificant. Strikingly, sub-Saharan Africa systematically receives less urban aid than do other regions, perhaps because the African Development Bank has not been active in urban lending.

The top four recipients of urban aid from 1995 and 2008 are dynamic, middle-income emerging-market economies: China, Brazil, India, and Mexico (figure 15.4). Together, they account for 30 percent of total urban commitments to all recipient countries from 1995 to 2008.

Urban aid suffers from the micro-macro paradox in the evaluation of its impact, with successful micro-level interventions (see below for evaluation evidence) but limited impact on aggregate compared with the scale of the urban challenge and the size of urban financing needs. A more comprehensive and reliable recording of aid data is necessary to assess the support of urbanization through aid flows and to persuade donors to increase the level of their support. Indicators need to be developed to measure results for urban development at the city level, which can be aggregated for the country. Lack of documented results hampers the flow of external assistance to urban development. At the same time, donors must improve their reporting to the Development Assistance Committee, using urban markers and other ways of identifying urban interventions, in order to support urban projects.

TABLE 15.1
Regression results for urban aid, 1995–2008*

Share	Urban aid/total aid [log (standard error); $n=98$]
Multilateral share of total aid (log)	0.206** (0.101)
Urban share of population (log)	0.00674 (0.268)
Government effectiveness	0.577*** (0.206)
Total aid/initial GDP (log)	0.267** (0.105)
Europe and Central Asia	−0.363 (0.439)
Latin America and Caribbean	0.339 (0.403)
Middle East and North Africa	0.175 (0.433)
South Asia	0.349 (0.597)
Sub-Saharan Africa	−0.909** (0.403)

* $R^2=0.250$.

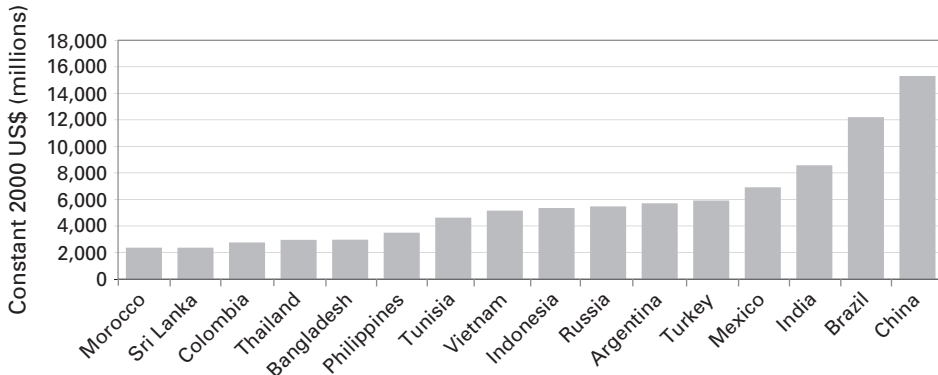
** $p < 0.05$.

*** $p < 0.01$.

SOURCE: Calculations based on AidData (2011).

FIGURE 15.4

Urban aid commitments by recipient, 1995–2008



SOURCE: Data from AidData (2011).

APPROACHES TO URBAN FINANCE AND LESSONS FROM EXPERIENCE BY SELECT AID AGENCIES

This section summarizes the guidance provided by donor strategy documents and compares it with the lessons from actual experience as reflected in donors' project and program evaluation documents. Eleven strategy documents for seven donor agencies were reviewed.⁵ They all share an overriding concern that urban local government capacity, accountability, and resources are generally very weak and in urgent need of strengthening if they are to be able to respond to rapid urbanization and severe urban physical and social infrastructure gaps. All strategy documents assign international development assistance an important role in helping to improve urban finance conditions as a key element for improving the performance of cities. None of them, however, focus specifically on metropolitan cities and how to assist them.

An examination of implementation showed no systematic assessment of experiences that donors had with their support for urban finance improvements. However, a sizable number of evaluations and reviews by three donor agencies for select areas of engagement and for some specific projects were analyzed. For the World Bank, three meta-evaluations are available (on municipal development projects [MDPs], projects in support of decentralization, and transport projects) and two reviews (on urban investment funds and lending for urban shelter).⁶ In addition, eight recent evaluation reports are available for 18 urban projects in eight countries. For the AsDB, one meta-evaluation on urban development projects and seven evaluation reports of urban development programs in six countries are available.

⁵These strategy documents are African Development Bank (2010), AsDB (2008a; 2008b; 2009a), Cities Alliance (2006), Dirie (2005), EBRD (2004), International Housing Coalition (2009), USAID (2011), and World Bank (2002; 2009a).

⁶Evaluations are formal assessments by independent evaluation offices of aid donors, such as the Independent Evaluation Group (IEG) of the World Bank, that apply a standard evaluation and performance rating methodology. Reviews are assessments by experts (generally staff from or consultants working for the aid agency) that do not follow a standard evaluation methodology and do not apply formal performance ratings.

For the European Bank for Reconstruction and Development (EBRD), a review of the implementation of its municipal and environmental infrastructure operations policy is available, carried out by the EBRD evaluation department.

The strength of these evaluations and reviews is that they offer a broadly representative overview of the experience on the ground and on a comparative basis relative to other interventions by the same aid agency, as well as others. The evaluations, however, also have significant limitations: (1) even though the focus is on the most recent of the available evaluation documents (from 2006 to 2011), many of the projects that they review were initiated 10 or more years ago; (2) they do not cover experiences after the evaluation was completed; (3) few focus in-depth on urban finance interventions; (4) few focus on the experience with donor support to specific metropolitan areas; (5) only very few evaluations involve controlled experiments, and none of them allows for a statistical test of significance of the findings; and, (6) different standards of evaluation across institutions are likely, and possibly biases among the evaluators.

Nonetheless, the information contained in these evaluations and reviews is of great value in providing insights into what donors have actually done and how this compares with the donor strategies, what has been the degree of success of their interventions, and what have been key constraints and lessons from their engagement. The universe of the urban projects and programs evaluated and reviewed is indeed large, and the total amount of lending (about US\$6 billion) is a significant fraction of the annual total annual ODA tracked in figure 15.1 (table 15.2).

The evaluations and reviews note that urban projects generally performed well, and in some cases better than the average project for the institution concerned over the period under review. For the World Bank's MDPs (reviewed in IEG 2009), 74 percent of completed projects were rated satisfactory, compared with 77 percent for all World Bank projects during the same period. MDPs performed best in Latin America and the Caribbean (86 percent satisfactory), above average in sub-Saharan Africa (75 percent), and worst in South Asia (43 percent). "Wholesale" projects (85 percent satisfactory) performed better than "retail" projects (67 percent). Annez, Huet, and Peterson (2008) found that municipal development fund (MDF) projects have done better on average than all World Bank projects and much better than World Bank credit-line projects. Buckley and Kalarickal (2006) noted that shelter projects were among the more successful of World Bank project areas, while the World Bank's Independent Evaluation Group (IEG 2007b) found that the performance of urban transport projects has been lower than average for transport projects from 1995 to 2005.

AsDB's and EBRD's urban projects generally performed equal to or better than projects in other sectors (AsDB 2006; EBRD 2010). Project performance assessments for AsDB find that single-city projects are performing substantially better than multicity programs. This is a striking difference from the World Bank's experience. AsDB (2006) ascribes the higher success rate of single-city projects to their simpler project design and institutional setup compared with multicity programs. One explanation for this difference between the experiences of AsDB and the World Bank might be that AsDB's single-city projects tended to involve fewer and less ambitious policy and institutional objectives than its multicity projects or the

TABLE 15.2

Key features of urban project evaluations and reviews

Evaluation/review (source)	Period	Number of projects	Amount of lending (annual average, billion US\$)	Performance* (percent rated at least satisfactory)
World Bank municipal development projects (IEG 2009)	1998–2008	190	14.5 (1.3)	74
World Bank MDF projects (Annez, Huet, and Peterson 2008)	Mid-1970s to 2006	NA	11 (0.4)	63
World Bank decentralization projects (IEG 2008b)	1990–2007	NA	22 (2.8)	NA
World Bank urban shelter projects (Buckley and Kalarickal 2006)	Mid-1970s to 2005	NA	16 (0.5)	83
World Bank urban transport projects (IEG 2007b)	1995–2005	78	NA	78
AsDB urban sector projects (AsDB 2006)	1999–2005	88	4 (0.4)	81
EBRD municipal and environmental infrastructure operations (2010)	1993–2009	202	4.5 (0.3)	61

*Ratings are not strictly comparable across evaluations because of different performance criteria applied and different time periods of review. In the case of the World Bank, project performance overall increased substantially from the 1970s to the 2000s. As a result, ratings for longer time periods are likely to be biased downward, compared with ratings for more recent periods.

World Bank's retail projects. Another explanation could be that AsDB's evaluations give less weight to policy and institutional factors than do those of the World Bank.⁷ More generally, AsDB (2006) notes that capacity-building and institutional development objectives were less frequently met than were overall project objectives.⁸

The remainder of this section reviews and contrasts the donors' strategic approaches and actual implementation experiences in seven areas of urban finance:

⁷For example, in the case of AsDB's loan to Vientiane, the evaluation concluded that the project was successful even though the project's "decentralized urban governance initiative was *partly relevant, ineffective, inefficient, and unlikely* to be sustainable" (AsDB 2010a, iv; italics in the original).

⁸AsDB project completion reports rate only 65 percent of projects successful in terms of their capacity building impact and only 50 percent in terms of institutional development.

decentralization; urban governments' own-source revenue mobilization; intergovernmental transfers; private finance; financial management and planning; partnerships and donor coordination; and scaling up.

Decentralization

Decentralization of governmental authority from the national to the local level is an important prerequisite for the effective development of urban government. Most of the urban strategy policy statements take the desirability and process of decentralizing responsibility and authority to lower levels of government as a given and, in effect, consider only how the capacity of urban governments to deliver improved services can be strengthened. The strategy report by the EBRD is an exception: it specifically postulates decentralization as a core objective, along with commercialization and environmental improvement (EBRD 2004). The report cites standard textbook arguments for decentralization, including better reflection of local preferences in public service provision and greater rationality and accountability in the use of public resources. However, with its principal focus on how to commercialize urban service delivery (including rational investment, cost-covering tariffs, independent management, and transparent and competitive procurement), even this strategy report does not address any of the complexities of design and implementation of decentralization reforms at the national or provincial level, which typically constrain the ability of local governments to improve their performance and the ability of aid organizations to support urban governments in their endeavors.

Only one recent evaluation assessed the results and quality of donor support for decentralization: the World Bank's evaluation of decentralization program funding in 20 countries from 1990 to 2007 (IEG 2008b).⁹ World Bank support was provided mostly in the form of loans involving general budget support for national policy and institutional reforms. These operations generally do not deal specifically with urban fiscal and governance issues, nor do they focus on metro cities in particular, but they approach the decentralization challenge as an issue of nationwide policy and institutional reform. For its assessment, IEG considered four major areas of World Bank intervention: reform of intergovernmental relations; increase in own-source revenues of subnational governments; improved debt management; and enhanced administrative capacity and accountability.

According to the evaluation, the overall results of bank support were closely aligned with two factors: whether the governments had clearly identified their decentralization objectives and whether bank support was aligned with those objectives. The evaluation found that, for most countries, World Bank support had modest or negligible impact.¹⁰ The report notes that, generally, the bank did not push for decentralization but assisted those countries that had identified

⁹No evaluations for other agencies address decentralization issues specifically, except that EBRD (2010) notes that policy dialogue in support of decentralization was an important component of EBRD municipal and environmental infrastructure operations.

¹⁰Interestingly, two of the high-impact cases involve postconflict countries, a fact that is not further addressed in IEG (2008b).

decentralization as a goal. In countries where the bank did push decentralization, such as Tunisia and Morocco, this had little effect (Annez, Huet, and Peterson 2008).

Results of World Bank support were generally better in the areas of helping countries developing suitable legal frameworks for decentralization and intergovernmental relations, creating transparent central governmental transfers, and improving public financial management at the subnational level. Areas of weak results included clarification of expenditure responsibilities, mobilization of own-source revenues at the local level, and introduction of citizens' oversight.

The evaluation report further notes that, overall, World Bank support was of mixed quality but did improve in more recent years. Principal weaknesses included variable quality of preparatory analyses of the decentralization challenge; weak understanding of the political economy; limited support for capacity building, especially at the subnational level; weak monitoring and evaluation (M&E), focused on process and outputs rather than outcomes; insufficient cooperation and coordination with other external donors; and lack of consistency in approach by different Bank organizational units supporting decentralization in a particular country.

The evaluation concludes with six recommendations for action: careful up-front analysis and development of an implementation plan; design of a comprehensive decentralization package involving fiscal, administrative, and governance reforms; selective support by the World Bank for parts of the overall package, with complementary engagement by other development donors; support for capacity building; a complementary mix of development policy loan and project loan support; and engagement for the long term.

Own-Source Revenues

All urban strategy documents agree that, in the wake of recent decentralization efforts in the developing world, local governments in general, and city governments in particular, have ended up with expanded expenditure responsibilities but that these have not been matched by sufficient increases in revenue authority. In addition, they note that local governments have not effectively used the revenue authority that they were given. Improving local revenue authority and effort is therefore a major, albeit difficult, thrust for official development agencies. Specifically, the Commonwealth Local Government Forum calls for the empowerment of local governments to raise their own resources in tandem with decentralization (Dirie 2005). The International Housing Coalition (2009) argues that they should be given more revenue authority, and the World Bank (2009a) urban strategy proposes to support local revenue-raising capacity and incentives for greater local revenue effort. The U.S. Agency for International Development (USAID 2011) supports improvements in cadastral services and municipal finance databases, while the Cities Alliance guidelines recommend greater reliance on cities' assets (especially land) and user fees (Cities Alliance 2006). EBRD (2004) focuses on cost recovery as part of its pursuit of commercialization of urban services but does not address the issue of the overall strengthening of the local revenue base. The World Bank's (2002)